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TITLE:

What's it all about?

What does good economic management mean in Australia?

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Summary

"The last Coalition government, of which I was a senior member, gave us, in its last four budgets the four biggest surpluses in Australian history." – Tony Abbott[1]

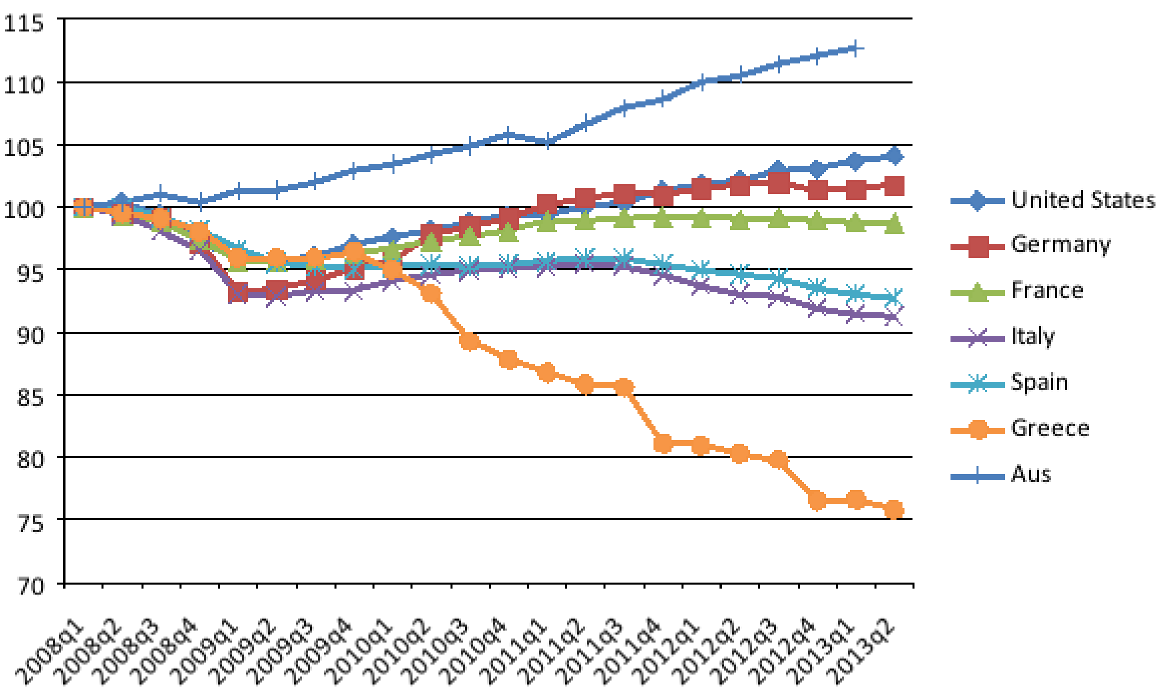
"Australian Labor governments know how to manage the great transitions in our economy." – Kevin Rudd[2]

Modern election campaigns in Australia are now fought on the often nebulous concept of who is the 'better economic manager'. Both parties work hard to portray the impression that they know how to make the economy 'strong' and that they will be better able to create 'jobs, jobs, jobs'.

But what do they mean? Are they referring to their ability to increase GDP growth or are they concerned with GDP per capita? Are budget deficits bad? Is jobs growth the same thing as falling unemployment? And if deregulation and small government are so effective, why has New Zealand's GDP per person fallen so far behind Australia's?

This paper considers the question of what is meant by good economic management. In addressing this question it considers both the long term perspective and the international perspective. Australia's post GFC experience is contrasted favourably with a broad range of other countries, especially countries that cut government spending as their economies slowed. As Figure 1 shows Australia's economic performance as measured by GDP has been superior to the rest of the developed world, especially when compared to countries that pursued cuts in government spending as their economies slowed.

Figure 1: OECD GDP Index since the Great Financial Crisis



Source: OECD (2013) *Quarterly national accounts: Quarterly growth rates of real GDP, change over previous quarter*

[1] Abbott, T (2013) People's forum: Rooty Hill RSL Club.

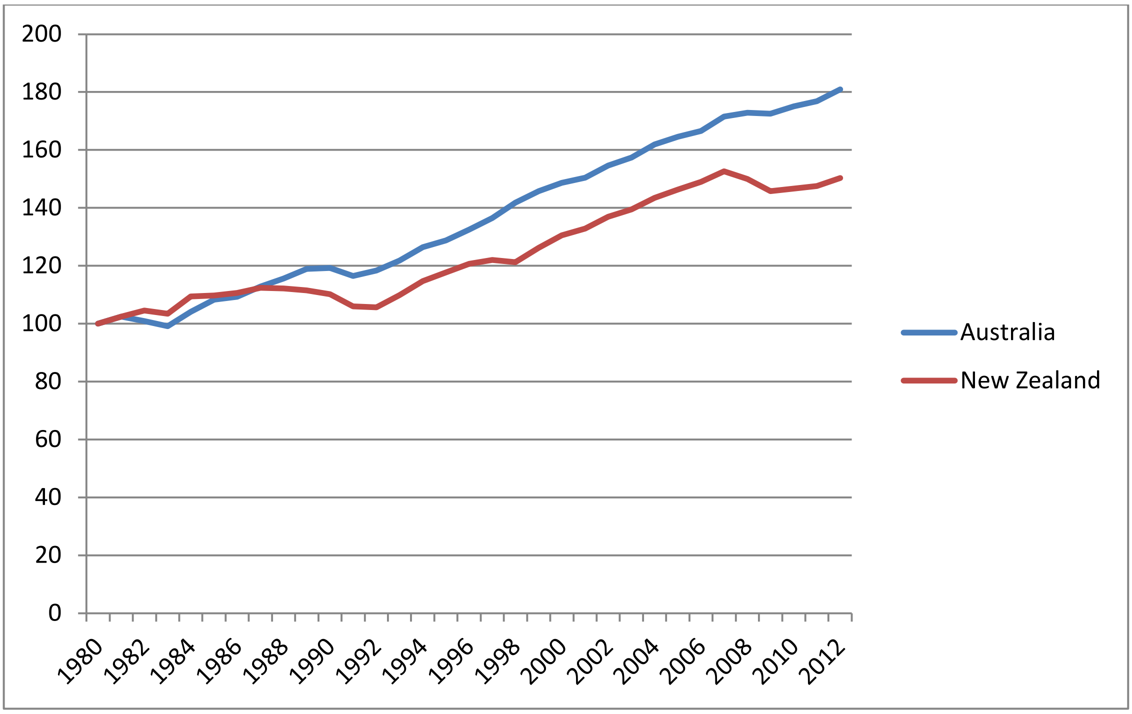
[2] Rudd, K (2013) Our national strengths are formidable.

The paper also considers the long term economic management of the major parties through the prism of the broad economic theories to which they have subscribed over time. It argues that, with occasional deviations, Labor's macroeconomic policy stance has been Keynesian ever since the Working Nation package introduced in the aftermath of the 1990-91 recession.

By contrast, the position of the LNP Coalition has been consistently anti-Keynesian. Since the election of the Howard government in 1996, the Coalition has taken the Classical view that governments should focus on balancing their budgets each year, leaving the Reserve Bank to manage interest rates with the goal of maintaining low and stable inflation.

While the Opposition has sought to compare Australia's economy to those struggling in Europe a more direct comparison may be made with New Zealand, which has been cited as a model by both Tony Abbott and Joe Hockey. New Zealand has pursued Classical policies such as privatisation, labour market deregulation and the pursuit of small government, with brief interruptions, for the last thirty years. As shown in Figure 2 the resulting economic outcomes have been little short of disastrous.

Figure 2: Australia and New Zealand Real GDP per capita (1980-2012)



Source: International Monetary Fund (2013) *World Economic Outlook Database, April*

After growing in parallel for nearly a century, the two countries have diverged to the point that New Zealand is near the bottom of the OECD league table, while Australia is at or near the top on most measures of economic performance.

A review of Australia's macroeconomic history since the early 1980s shows how Classical economics has failed in its predictions and policies, and how Keynesianism has succeeded, whenever it has been given a chance. Despite this record, Classical thinking remains dominant in much of the policy debate.

It is often said within economics that the economy has more impact on the budget than the budget has on the economy. While our modern political debate may have reduced the notion of economic management to something as simple as the size of the budget deficit or surplus, in reality, economic theory and history offers no such simplicity. A budget surplus is neither good nor bad, instead it needs to be evaluated in the context of the macroeconomic circumstances in which it was returned. Indeed, the IMF recently chided the Howard government for being profligate in its spending at a time it was delivering budget surpluses. Put simply, the IMF concluded that the Howard surpluses should have been much bigger.

This paper concludes that Keynesian macroeconomic policies have outperformed Classical policies aimed at reducing budget deficits as an end in itself. It also concludes that New Zealand's implementation of Classical micro and macroeconomic policies has been economically disastrous.

To the extent that evidence plays a role in debates about economic management in Australia, those arguing for Australia to pursue the policies that have failed New Zealand should explain why it is that the New Zealand economy is not very 'strong'.

Introduction

For nearly a century, arguments about how to manage the economy have divided economists into two broad camps: Classical and Keynesian. Although the lines of debate are inevitably obscured by opportunism and point scoring, the current election may be seen as a referendum on which of these approaches is best for Australia.

The Classical view was first stated explicitly in the early 19th century, and has remained influential ever since. In essence, it states that governments can do nothing useful about recessions and depressions, except to get out of the way and allow private economic activity to recover. In particular, governments should seek to balance their budgets at all times, to avoid taking on debt and 'crowding out' more productive private sector activity. The Classical view of economic management at the aggregate level is associated with 'free-market' views about economic policy in general, and particularly with support for a large, and largely unregulated, financial sector.

Over the course of the 19th and early 20th centuries, the Classical view was refuted by long practical experience, which showed that market economies are subject to repeated recessions and depressions, as well as speculative booms, a phenomenon known as the business cycle. It was not until the Great Depression, however, that John Maynard Keynes developed both a theoretical analysis of recessions and a policy response. Keynes showed that, contrary to the Classical view, unemployed could remain high for sustained periods as a result of a lack of adequate effective demand. The appropriate policy response was for governments to stimulate the economy during recessions by increasing public expenditure and reducing taxes. The resulting deficits, Keynes argued, should be offset by accumulating surpluses during boom periods. As he observed in a letter in 1937 'the boom, not the slump is the time for austerity at the Treasury'.

With occasional deviations, Labor's macroeconomic policy stance has been Keynesian ever since the *Working Nation* package introduced in the aftermath of the 1990-91 recession, itself the result of free-market policies of financial deregulation and contractionary monetary policy. The success of *Working Nation*, during the short period it was in operation, helped to shift views in the Australian economics profession back towards Keynesianism, which had fallen into disfavour during the 1980s.

By contrast, the position of the LNP Coalition has been consistently anti-Keynesian. Since the election of the Howard government in 1996, the LNP has taken the Classical view that governments should focus on balancing their budgets over the cycle, leaving the Reserve Bank to manage interest rates with the goal of maintaining low and stable inflation. Essentially the interest rate policy of the RBA was treated as the main instrument to provide economic stability. Provided the right microeconomic institutions are in place, the Classical view is that the economy will automatically tend towards full employment and steady growth.

The crucial test of the competing views was the Global Financial Crisis of 2008 and 2009. Labor's response, based on a large-scale program of fiscal stimulus followed by a gradual return to surplus, was thoroughly Keynesian in its aggregate approach and in much of the detail. Although the debate was side-tracked for several years by a dogmatic, and ultimately undeliverable, commitment to a return to surplus by 2012-13, Labor's current policy is broadly Keynesian. By contrast, the LNP Opposition opposed fiscal stimulus at the time and has railed against the resulting deficits and debt ever since.

Australia's policy approach and macroeconomic outcomes stand in sharp contrast to those observed in countries that rejected fiscal stimulus, or switched early from stimulus to austerity. The most dramatic contrasts are with peripheral European economies, forced into austerity under pressure from institutions like the European Central Bank, but these countries differ from Australia in many ways. A more direct comparison may be made with New Zealand, which has been cited as a model by both Tony Abbott and Joe Hockey. New Zealand has pursued Classical policies, with brief interruptions, for the last thirty years. The resulting economic outcomes have been little short of disastrous. After growing in parallel for nearly a century, the two countries have diverged to the point that New Zealand is near the bottom of the OECD league table, while Australia is at or near the top on most measures of economic performance.

In this paper, the contrast between Keynesian and Classical views will be developed, with particular emphasis on the Keynesian concept of the multiplier effect and the alternative 'crowding out' theory of Classical economics. The recent macroeconomic history of Australia will be examined to show how Keynesian policies have consistently succeeded, while Classical policies have consistently failed. The comparison with New Zealand will be developed further to demonstrate the disastrous costs that may arise from adherence to Classical policies.

An overview of Keynesian & Free-market approaches to macroeconomics

The Classical view, dating back to the 19th century is based on the idea that the economy is self-stabilizing. Recessions and depressions may occur as a result of unexpected shocks, but there is nothing governments can or should do about them.

Classical economists had both a theory of how prices are determined in individual markets so as to match supply and demand ("partial equilibrium theory") and a theory of how all the prices in the economy are jointly determined to produce a "general equilibrium" in which there are no unsold goods or unemployed workers.

The strongest possible version of this claim was presented as Say's Law, named, somewhat misleadingly, for the Classical economist Jean--Baptiste Say[3]. Say's Law, as developed by later economists such as James Mill, states, in essence, that recessions are impossible since "supply creates its own demand."

Because it represents the economy as a whole as being just like a single household, the Classical model has intuitive appeal both for economists and for ordinary people. For economists, the appeal is that of elegance and simplicity - a single model explains everything from individual decisions to a large and complex economy. For ordinary people, the prescriptions of Classical economics sound like common sense. The injunction to governments to 'balance the budget and let the economy look after itself' is very like the standard (pre-decimal currency) advice to households 'look after the pennies and the pounds will take care of themselves'.

The deficiencies of the Classical model were widely recognised as early as the mid-19th century. The fact that market economies were subject to periodic crises was central to the Marxian theory that capitalism would ultimately destroy itself. However, the Marxian assumption that crises would inevitably become more and more severe has proved to be false. Another attempted explanation of the business cycle, based on the observation of overinvestment during booms and underinvestment during slumps was developed by the Austrian economists, notably Hayek, Mises and Schumpeter. As with Marx, the Austrian theory of the business cycle had some useful insights but some critical failures, notably the inability to explain unemployment. Also in common with Marx, the theoretical vigour of the early years of Austrian economics turned into ossified dogma in the hands of a self-identified 'Austrian school'.

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3 Say himself was not a dogmatic adherent of Classical economics. In fact, he was sympathetic to the idea of using public projects to reduce unemployment during recessions

For practical purposes, macroeconomics began with Keynes' *General Theory of Employment, Interest, and Money.* The point of Keynes's title was that "general equilibrium" was not general enough. A fully general theory of employment must give an account of recession states where unemployment remains high, with no tendency to return to full employment.

In the simplest version of the Keynesian model, equilibrium can be consistent with sustained unemployment because, unlike in the Classical account of Say, the demand associated with workers' willingness to supply labour is not effective and does not actually influence the decisions of firms. Unsold goods and unemployed labour can coexist. Such failures of coordination can develop in various ways, but in a modern economy, they arise through the operation of the monetary system.

A simple and homely illustration is provided by Paul Krugman's description of a babysitting cooperative in Washington, DC, where babysitting credits worked as a kind of money. When members of the group tried to build up their savings by babysitting more and going out less, the result was a collapse of demand. The problem was eventually addressed by the equivalent of monetary expansion, when the cooperative simply issued more credits to everyone, resulting in more demand for babysitting, and a restoration of the original equilibrium.

Keynes's analysis showed how monetary policy could work, thereby extending the earlier work of theorists such as Irving Fisher. However, the second part of Keynes's analysis shows that the monetary mechanism by which equilibrium should be restored may not work in the extreme recession conditions referred to as a "liquidity trap." This concept is illustrated by the experience of Japan in the 1990s and by most of the developed world in the recent crisis. Even with interest rates reduced to zero, banks were unwilling to lend, and businesses unwilling to invest.

Keynes' General Theory provided a justification for policies such as public works programs that had long been advocated, and to a limited extent implemented, as a response to the unemployment created by recessions and depressions. More generally, Keynesian analysis gave rise to a system of macroeconomic management based primarily on the use of fiscal policy to stabilize aggregate demand.

During periods of recession, Keynesian analysis suggested that governments should increase spending and reduce taxes, so as to stimulate demand (the first approach being seen as more reliable since the recipients of tax cuts might just save the money). On the other hand, during booms, governments should run budget surpluses, both to restrain excess demand and to balance the deficits incurred during recessions.

Keynes's ideas had little impact on the policies pursued during the Great Depression, although some aspects of the New Deal in the United States and of the policies introduced by social democratic governments in Scandinavia and New Zealand could be seen as Keynesian in retrospect. The crucial contrast was between the experience of World War I and its aftermath, ending in the Great Depression, and that of World War II and the successful economic reconstruction that followed it

Keynesian economic management was applied with great success in the decades after 1945. For most developed countries, the years from the end of World War II until the early 1970s represented a period of full employment and strong economic growth unparalleled before or since. With declining inequality and the introduction of more or less comprehensive welfare states, the gains were greatest for those at the bottom of the income distribution.

However, the inflationary upsurge of the 1970s produced an anti-Keynesian backlash under the banner of 'New Classical Macroeconomics'. In the end the 'New' components, such as the idea of that business cycles could be explained by technological shocks or changes in the preferences of workers, proved to be of little value. In the end, ‘New Classical’ macroeconomics is little different from the 19th century version. The only difference is that we now have another 100 years of evidence showing the Classical economics is wrong, and that the Keynesian account of recessions and depressions is broadly correct.

An overview of the role of, and evidence for, multiplier and crowding out effects is provided in Appendix A.

Budget balance and fiscal policy

The main long-term constraint on fiscal policy is that the ratio of public sector net worth (or, more commonly, net debt) to national income should remain stable over the long term, preferably at a level that provides room for substantial additional borrowing if the need arises. A policy that allows debt to grow without limit cannot be sustained indefinitely, though there is no clear point at which the debt position becomes untenable. Broadly speaking, debt will increase when the government budget is in deficit and decrease when it is in surplus. So, if stability is to be sustained, deficits and surpluses must balance over time.

In one form or another, nearly everyone accepts this broad principle. But the simple statement above conceals a range of complexities regarding terms like “debt” and “deficit”, and the phrase “over time”.

There are two measures of public debt that need to be considered.

First, and most important, is the net worth of the public sector, that is, the difference between the value of publicly-owned assets and the debt incurred to finance those assets. Historically, these two values have been about equal, so the net worth of the Australian government has been around zero, ranging from 6 per cent of GDP just before the crisis to negative net worth of −6 per cent in 2011-12. Net worth is the most relevant measure of a government’s financial position in the long run.

The second measure is net financial worth, which excludes non-financial assets such as schools, hospitals, roads and so on, but includes the value of public enterprises such as Australia Post. Investments in non-financial assets generate a flow of services, but no monetary return. Hence, they must be financed over time by tax revenue. In Australia, most such assets are owned by state governments, so the impact on the Commonwealth is modest.

The importance of using correct measures can be seen by looking at the results of privatisation and other asset sales. Asset sales improve the government’s cash balance in the year they take place, and they reduce ‘gross’ measures of public debt, which do not take assets into account. But selling income-generating assets makes no difference to the government’s financial position, unless the asset is sold for more than its value in continued public ownership, that is, unless the interest that can be saved by using the sale proceeds to repay debt exceeds the value of the flow of dividends and retained earnings from the continued ownership of the asset.

Turning from measures of the government’s financial position at a point in time to measures of annual flows, the most useful concept of budget balance, sometimes called primary budget balance, is simply the difference between government revenue and operating expenditure. This measure does not include interest on government debt or income flows from financial assets. Assuming the rate of interest on government debt is equal to the rate of growth of national income, the addition of interest to the existing debt will leave unchanged the ratio of debt to national income.

This point may be illustrated by an example. Suppose public debt is equal to 30 per cent of national income, which is initially one trillion dollars a year, so that debt is $300 billion. Suppose also that the rate of interest on public debt and the rate of growth of national income are both 5 per cent. With a primary balance of zero, public debt will grow by the amount of interest paid, which is 15 billion (5 per cent of $300 billion). But national income will also grow by 5 per cent, to 1.05 trillion. It's easy to check that the ratio of debt to income remains unchanged at 30 per cent, and that this result does not depend on the specific values in the example.

It is, not, however, generally desirable to pursue the goal of primary balance every year. There are several reasons for this. First, and most importantly, countercyclical fiscal policy requires governments to run deficits during recessions and surpluses during booms. Sustainability requires that, over the course of the economic cycle, deficits and surpluses must balance out.

Finally, if the rate of interest on public debt differs substantially from the rate of growth of national income, it may be necessary to adjust the rule. If the rate of interest on public debt is below the rate of growth of national income, primary balance will produce a declining ratio of debt to national income. For most of the period after World War II, the combination of low interest rates, strong growth and moderate inflation meant that the interest rate on public debt was well below the rate of growth of national income, and government budgets were mostly in primary balance or modest surplus. The result was a steady reduction in the ratio of public debt to national income. This was a desirable outcome, given the very high levels of debt prevailing at the end of the war. At more moderate debt levels, however, such a policy entailed an excessive accumulation of financial assets at the expense of public investment.

Although the precise measurement of budget balances and public balance sheets is complex, the central issue is the very simple one raised at the beginning of this section. In the language of economists, fiscal policy satisfies the long-term intertemporal budget constraint if, and only if, it is consistent with a stable long-term ratio of public debt to national income.

Australian macroeconomic policy since 1983[4]

From World War II until the early 1980s, Australia's economy followed a path similar to that of other developed countries. Three decades of successful Keynesian macroeconomic management ended with the inflationary spiral of the 1970s, culminating in the breakdown of the Bretton Woods system of managed exchange rates, and the deregulation of the financial system. By the late 1970s, most countries had abandoned Keynesian fiscal policy in favour of attempts to control the money supply, following the then-fashionable monetarist version of free-market economics, popularised by Milton Friedman.

Australia followed this pattern in general, but there were a number of critical episodes in which the adoption of Keynesian-inspired policies produced outcomes superior to those of other countries in similar circumstances that followed Classical policies. As the exception that proves the rule, the 'recession we had to have' from 1989 to the early 1990s, demonstrated the failure of free-market assumptions about the finance system and the macroeconomy.

A review of Australia's macroeconomic history since the early 1980s shows how Classical economics has failed in its predictions and policies, and how Keynesianism has succeeded, whenever it has been given a chance. Despite this record, Classical thinking remains dominant in much of the policy debate.

The Accord

The first important divergence between Australia and the rest of the world came with the adoption of the Accord in 1983. Australia's relatively rapid recovery from the chaos of the 1970s can be attributed to the success of this Keynesian-inspired idea.

In 1983, the newly elected Hawke Labor government faced two major economic problems. The first was to bring an end to a wage-price freeze that had been imposed by the Fraser government: as usual, this measure had achieved some short-term success, but was rapidly proving unsustainable. The second was the need for stimulus to promote recovery from a deep recession. In both cases, the risk was that taking the necessary measures would lead to resurgence in inflation.

In response, the government reached an agreement with the trade unions referred to as 'The Accord'. Under the Accord, unions agreed to reduce the rate of growth of wages in return for an expansionary fiscal policy and an increase in the 'social wage', most notably the (re)introduction of a national system of health insurance (Medicare). The policy met with immediate success. Unemployment rates fell sharply, while the rate of inflation gradually declined.

Despite the success of the Accord, the government shifted rapidly in the direction of Classical economics during the 1980s. The floating of the dollar in late 1983 and the associated deregulation of financial markets made the government dependent on the goodwill of 'the markets', particularly as embodied by the credit ratings agencies, which were seen as the best judges of national economic performance.

The 'Trilogy' commitments (to constrain the share of government revenue and expenditure in national income and to reduce the budget deficit) made in 1984 marked the abandonment of Keynesian fiscal policy as a guiding principle for the government. The initial consequences were limited because a reduction in the deficit was consistent with the gradual withdrawal of

[4] See Junankar (2005) for a discussion of a comparison of the Labor and Coalition governments' economic management of the Australian economy.

fiscal stimulus implied by a Keynesian stance. The full implications became evident only during the recession that began in 1989.

The 1989 recession

The biggest macroeconomic policy mistake in Australia was the adoption of a combination of monetary and fiscal contraction, leading to the 'recession we had to have' in 1990. The fiscal tightening could be justified as part of a gradual process of consolidation under favourable economic conditions, consistent with the Keynesian prescription of running surpluses during booms. By contrast, the sharp and sustained increase in interest rates, which saw the cash rate reach 18 per cent in the second half of 1989, was a recipe for disaster

Various reasons were advanced, at the time and subsequently, for the high-interest rate policy, including a large current account deficit, the emergence of a speculative boom in real estate prices, and the need to wind back the monetary expansion that had been introduced in a response to the 1987 stock market crash. All of these rationales reflected failures of financial deregulation rather than coherent arguments for contractionary monetary policy.

More importantly, and presaging mistaken international thinking about the 'Great Moderation' of the 1990s and 2000s, policymakers mistakenly believed that the free-market microeconomic reforms of the 1980s had rendered the economy so resilient that it could easily recover from temporary shocks.

As measured by the contraction in GDP, the recession was not particularly severe, lasting from September 1990 to September 1991, and reducing GDP by 1.4 per cent. The 1982 recession was deeper and longer.

In terms of unemployment, however, the 1990s recession was the worst in post-war history. The unemployment rate rose from 6 per cent to 10 per cent over the course of the recession and kept on rising for another year, remaining above 10 per cent until the introduction of the Working Nation package in 1994.

The blame for this disaster can be placed squarely on the embrace of Classical economic thinking. Years after the depth of the recession had become apparent; the Hawke-Keating government resolutely refused a shift to Keynesian policies, using the common metaphor of 'pump-priming' as a term of derision. In 2010 Caunce[5] observed:

> *As the economy entered into recession in 1990-91, once more the Hawke Government refused to utilise Keynesian fiscal stimulus to reinvigorate demand. Keating (1990, 2) informed the nation that the 1990-91 Budget 'maintains fiscal policy as the Government's principal weapon in the fight against the current account deficit and our overseas debt'. The following year, and in spite of the evident recession, Keating's 22 May Expenditure Review Committee submission expressed his advocacy for the retention of the structural surplus (see Hawke 1994, 540-1), a tool to constrain the current account deficit for which Treasury (1991, 2.37) maintained support. This 'formed ... the basis on which John Kerin drew up that [1991-92] Budget', after Keating had resigned in June 1991 (Hawke 1994, 542). Labor 'rejected any suggestion that the Government would seek ... a return to the "twin objectives" of fighting inflation and unemployment followed in the early years of the Hawke Government' (Tingle 1994, 132). The Government did*

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[5] Caunce, T (2010) *The Rudd Government and Labor's return to Keynesian social democracy.*

not want to deliver a pro-cyclical stimulus, just as 'the economy was on the mend' (Kerin 1991, 14).

Working Nation

The failure of the economy to recover in line with the predictions of the Classical model led to a gradual shift back towards Keynesian thinking in the government, symbolized by a very modest package of infrastructure projects announced in 1992 under the title (later to become much better known in another sense) *One Nation.*

However, no real response to the rise in unemployment took place until after the 1993 election, when the Keating government appointed the Committee on Employment Opportunities. Its report, commonly referred to as the Green Paper, called for the adoption of a range of measures with an estimated net cost of around $2 billion per year, which could be financed by a 'jobs levy' similar to the Medicare levy.

In response, the Keating government introduced Working Nation, a program with a budget of $1 billion in 1994-95, financed from general revenue rather than a hypothecated tax (Commonwealth of Australia 1994). Expenditure was projected to increase to nearly $2 billion by 1996-97, but the program was scaled back in the 1995-96 Budget, and scrapped by the newly-elected Howard government in 1996.

The central principle underlying the Working Nation labour market programs was the Job Compact, under which the government committed itself to offer 'substantial paid employment' to all workers unemployed for 18 months or more. The reciprocal obligation was that workers were obliged to accept 'a reasonable offer of a job' or lose entitlement to benefit.

The Working Nation program had three main components: training schemes similar to those already in place; an expanded version of a wage subsidy scheme called Jobstart, introduced on a small scale in 1991; and a job creation scheme called New Work Opportunities.

Working Nation, along with a broader shift towards fiscal stimulus, had an immediate effect, with unemployment falling from 10 per cent to 8 per cent. However, with the government facing criticism regarding the size of the deficit, the program was scaled back in the 1995 Budget, before being scrapped altogether by the Howard government in 1996.

The recovery in employment stalled with the abolition of Working Nation and the resurgence of a Classical focus on budget balance. The unemployment rate remained at or near 8 per cent until 1999.

The Howard Years

The Howard government, elected in 1996, inherited a Budget deficit of about 2 per cent of GDP, which reflected the slow recovery from the deep recession of 1990 and 1991. As has become customary, this unsurprising outcome was dramatized as the discovery of a 'Black Hole', and used to justify the abandonment of those election promises deemed to be 'non-core'.[6] The 1996-97 Budget introduced some sharp cuts in public expenditure and led to

[6] After breaching a number of promises, Howard justified his position by saying, that the government had delivered its 'core commitments', notably in interviews with John Laws and Kerry O'Brien August 21 1996, though it appears he had used the phrase before this. It is not clear who coined the term 'non-core' but it was in widespread use soon after the Laws interview, and dogged Howard throughout his term in office.

the restoration of Budget balance by 1997-98. Thereafter, the Budget balance was maintained with a run of modest surpluses averaging around 1 per cent of GDP.

Howard's approach to fiscal policy was based, on a combination of free market macroeconomic theory and political calculation. As has been discussed above, the free-market model allows no role for fiscal policy in stabilizing the economy, relying exclusively on monetary policy.

Howard was fortunate that his Prime Ministership coincided with the (ultimately spurious) Great Moderation, a period during which macroeconomic shocks were sufficiently modest to be handled by central banks, using modest adjustments to interest rates (usually in steps of 0.25 per cent). He was also fortunate that the Reserve Bank of Australia, unlike its New Zealand counterpart, made the right call in response to the one major potential shock during his term of office, the Asian financial crisis of 1997.

Howard's political calculation was reflected in the timing of fiscal policy. On the one hand, having assailed the preceding Labor government for running deficits in the wake of the recession, it was important to keep the Budget in surplus at all times and, with the occasional use of accounting tricks, he did so. On the other hand, as elections approached he adopted a more expansive approach, cutting taxes and introducing new expenditure programs.

The key political calculation was that Labor would be unwilling to withdraw the newly introduced benefits, and therefore unable to make expensive commitments of its own without the risk of running into deficit. The terminology of the time, in which the surplus accrued in the early years of a Parliamentary term was referred to as an election 'war chest' illustrated this thinking.

The Treasury, aware that good economic times would not last forever, was concerned that a golden opportunity to build up public sector net worth was being squandered. Reflecting the views of his Department, Howard's Treasurer and rival, Peter Costello, sought to quarantine some of the surplus in the 'Future Fund'. As of 2013, the Fund had built up assets of $85 billion, or about 5 per cent of GDP. However, most of this sum was derived from the sale of assets such as Telstra. Hence, it did not constitute net savings but only a reallocation of public sector wealth.

Reviewing 200 years of government records across Australian history, the International Monetary Fund found only two periods of notable profligacy in Australia's history, both in the later years of the Howard government.[7] The IMF finding supported a Treasury study which showed unprecedented growth in spending over the final four years of the Howard government.

Some of the worst aspects of Howard's fiscal legacy did not show up during his term of office, but took the form of long-term commitments with which he sought to bind his successors.

The most important of these related to income tax scales. Howard cut income tax rates at regular intervals during his period in office. For most of his term, the cuts in income tax rates were fiscally neutral, either returning the extra revenue derived from bracket creep or financed out of the additional revenue derived from the introduction of the GST in 2000.

In the lead up to the 2007 election, however, Howard promised, if re-elected, to introduce more substantial tax cuts over the term of the next Parliament, along with even more expensive 'aspirational' tax cuts to follow. Labor felt compelled to match these promises, with

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[7] The only period of notable 'prudence' was during the Depression, an occasion when prudence, also referred to as austerity, was positively harmful. The IMF correctly judged the Rudd's government's fiscal stimulus in 2009 as a sensible response to adverse economic conditions.

minor modifications. In the wake of the Global Financial Crisis, the 'aspirational' component of the Howard tax cuts was abandoned, but the remaining cuts were delivered in full, even though lower rates of real and nominal economic growth had made them less affordable.

Howard also expanded tax expenditures, particularly including concessions for superannuation, which favoured wealthy self-funded retirees at the expense of pensioners.

The GFC

The GFC came as a complete surprise to the Classical economists who dominated the profession by the early 2000s. The financial sector had expanded massively since the deregulation of the 1970s and 1980s, to the point where total assets and liabilities were measured in the hundreds of trillions. Moreover, with the exception of interest rate adjustments, governments and central banks had abandoned most of the tools that might be used to manage the economy, from fiscal policy to direct financial controls.

Far from viewing these developments with concern, Classical economists credited them with what they predicted would be a permanent end to major recessions, the so-called Great Moderation. There was some disagreement as to how much of the credit should go to financial liberalization, and how much should go to monetary policy based on inflation targeting, but widespread agreement that the Great Moderation was a definitive refutation of the 'Old Keynesian' view that had prevailed until the 1970s.

For those whose views rested on historical experience rather than theory, the growth of massive imbalances in borrowing and lending was a cause for concern, though it was impossible to predict when and how concern might turn into crisis.

By late 2006, loans to borrowers with weak or non-existent credit formed the basis of an inverted pyramid amounting to trillions of dollars of spurious assets created by banks and hedge funds around the world. Some of these institutions were explicitly backed by national governments. Many others were "too big to fail" or, more precisely, too interconnected to fail. Given the complex and fragile web of financial transactions built up since the 1970s, the breakdown of even a medium--sized player could bring the whole system to a halt.

The stage was set for a global economic meltdown. The crisis built up slowly over the course of 2007, as the growth in house prices slowed, and "subprime" borrowers faced foreclosure. By mid--2007, the problems had spread more widely, to classes of borrowers seen as less risky. CDOs and other derivatives, originally rated as AAA, were downgraded on a large scale and some went into default.

Throughout all this, the dominant view, informed by faith in financial markets, was that nothing would, or could, go badly wrong. It was not until investment bank Bear Stearns was rescued from imminent bankruptcy in March 2008, that confidence started to crack. By this time, as the National Bureau of Economic Research subsequently determined, the U.S. economy had been in recession for several months. But as late as August 2008, the most common response from financial markets was that of denial.

The meltdown began with the sudden nationalization of the main U.S. mortgage agencies, Fannie Mae and Freddie Mac in early September 2008. Two months later, the investment banking industry had collapsed, with Lehman Brothers bankrupt, Merrill Lynch swallowed by Bank of America, and Goldman Sachs, and JP Morgan forced to seek the safety of government guarantees, by becoming bank holding companies. A year later, the list of casualties included banks around the world, whole countries such as Iceland, and the archetypal embodiment of corporate capitalism, General Motors.

For a variety of reasons, Australian financial institutions had relatively modest exposure to the toxic financial assets that drove the first stage of the crisis. As a result, Australian policymakers had plenty of advance warning. Problems with the global financial sector were evident at least from the collapse of Bear Stearns in March 2008, giving monetary authorities time to prepare a response to the meltdown that took place in September of that year. Broadly speaking this response was effective in insulating the Australian financial sector from the global collapse.

Fiscal policy similarly had more advance warning than usual, and the Australian government responded more rapidly and vigorously than many others. The economy was still growing strongly when the global crisis hit in late 2008. An immediate cash handout, costing $10 billion, delivered in December 2008 moderated the immediate shock. A much larger stimulus package, estimated at 42 billion, passed by Parliament in early 2009, included a wider range of cash payments, infrastructure measures such as the Building Better Schools program and the home insulation program, and an investment credit for small business.

The total stimulus was equal to around 4 per cent of GDP, though not all of it was spent in 2009-10. In addition, there was a stimulus arising from automatic stabilizers, that is, the decline in tax revenue and increase in welfare spending that arises when the economy slows.

Unlike the relaxation of monetary policy, which received broad support, the fiscal policy response to the crisis was controversial. The stimulus package was rejected by the main Opposition parties, passing the Senate with the support of Greens and Independents. It was criticised by Classical economists and conservative think tanks. Initially, much of the criticism focused on the specifics of the package, based on claims of poor targeting and of waste in spending.

Over time, however, the focus of criticism moved to the more fundamental issues of the validity of fiscal stimulus, and the claim that deficits are always undesirable.

This criticism gained strength with the emergence of sovereign debt problems in numerous European countries, beginning with Greece, and the adoption of ‘austerity’ policies aimed at reducing public debt and encouraging the growth of the private sector. The catastrophic failure of these policies has had almost no impact on the advocates of austerity

Faced with Australia’s obvious success, and the equally obvious failure of austerity, it would seem to be impossible for supporters of the Classical view to deny the facts. But nothing is impossible for a committed ideologue.

The main claim made to explain Australia’s strong economic performance has given the credit to the mining boom and to demand from China. The first of these claims does not stand up to minimal scrutiny. The GFC had a severe and immediate effect on world trade, and particularly on commodity prices, which persisted through 2009.

Moreover, the relatively rapid recovery of the minerals sector was due to the adoption of massive fiscal stimulus measures in China. The Classical position relies on the nonsensical claim that fiscal stimulus in China was effective enough to provide a substantial flow-on benefit to Australia, but that fiscal stimulus in Australia had no effect.

International comparisons

New Zealand versus Australia

A comparison between Australia and New Zealand provides some particularly strong evidence on the effects of Keynesian and Classical macroeconomic policies. The LNP has repeatedly pointed to the fact that New Zealand undertook much less fiscal stimulus during the GFC than Australia and is projected to return to surplus much earlier. In 2010, for example, Tony Abbott stated:

> *There are other countries which have chosen a different path and there's no evidence that their response has been any less effective than ours. For instance, in New Zealand they have tried to reform their way through the global financial crisis under the new government's leadership and they seem to be doing pretty well.*[8]

More recently, responding to the 2013-14 Budget, Shadow Treasurer Joe Hockey commented:

> *How can the Australian treasurer insist that the Government's budget of deficits, higher unemployment and slower economic growth is unavoidable when New Zealand has been able to deliver an earlier surplus without a major resources industry and a strong New Zealand dollar?*[9]

Hockey's statement implies, entirely falsely, that New Zealand has performed better on the relevant measures of unemployment and economic growth. In fact, as is shown in Figure 2, New Zealand's pursuit of budget surplus has come at the expense of employment and growth.

Contrary to Hockey's assertion, GDP per capita improved in real terms in Australia throughout the 2000s at a rate higher and more consistent than comparable growth in New Zealand. The pursuit of an arbitrary budget surplus in the years post-GFC, rather than promoting overall growth, have in fact hampered it.

The (then) Shadow Treasurer is not alone in his confidence in New Zealand's economic performance. Such statements reflect a consistent pattern over the past thirty years. During most of this period New Zealand economic policy has been dominated by Classical macroeconomics and free-market philosophy. Advocates of these policies have consistently predicted superior economic outcomes. For example, the late PP McGuinness[10] suggested that New Zealand 'shows every sign of being on the brink of overtaking Australia perhaps before the centenary of Federation in terms of living standards and economic performance'.

The reality has been far different.

For most of the 20th century, income per person in New Zealand grew in parallel with Australia. According to the Penn World Tables, income per person in New Zealand was within 10 per cent of the Australian level for most of the period from 1950 to 1970. Since the 1970s, NZ has declined greatly relative to Australia. On the latest Penn World Table figures, income per person is about 70 per cent of the Australian level.

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[8] Abbott, T and Kelly, F (2010) Radio National, Breakfast, 11 February.

[9] Chapman, K (2013) *Strewth mate, hold on a bit,* Stuff, New Zealand, 15 May.

[10] quoted in Rankin, K (1995) *New Zealand 1995: a miracle economy?*

Over much of this period, New Zealand's economic management has been in the hands of radical advocates of the free market. Among the most important were Roger Douglas and David Caygill, finance ministers in the Labour government from 1984 to 1990, Ruth Richardson, their National Party successor and Donald Brash, governor of the Reserve Bank of New Zealand from 1988 to 2002, and later leader of the National Party and then of the (radical free market) ACT Party. The free-market spell was broken by the Labour government of Helen Clark, but resumed (though in a less extreme form) with the return of a National government (supported by ACT) in 2008

The free-market managers of the NZ economy made a serious of disastrous errors in macroeconomic policy, with the result that since 1984, New Zealand has had five recessions, while Australia has only had one (the 1989-91 recession, which coincided with a similarly severe downturn in New Zealand).

The most important instances were:

- The 1980s (Rogernomics) period when New Zealand undertook radical microeconomic reform and pursued Classical macroeconomic policies then referred to as monetarism with the aim of reducing inflation. By contrast, for most of the 1980s, Australian policy was centred on the Accord. The result was a pair of recessions encompassing most of the period from 1987 to 1991. Australia's recession in this period was not as severe
- The 1997 Asian financial crisis, when the Reserve Bank of New Zealand resisted depreciation of the NZ dollar, on the view that this would be inflationary, while the Australian dollar was allowed to fall freely, matching the depreciation of our Asian trading partners
- The GFC when the Australian government implemented a large and sustained stimulus while New Zealand undertook a limited stimulus and sought a more rapid return to surplus.

The results speak for themselves. Whereas Australia has consistently outperformed the OECD average over the past thirty years, New Zealand's rate of economic growth has been among the lowest in the developed world. NZ income per person is now 30 per cent below the Australian level. Standard economic theory suggests that, when two countries have access to the same technology, comparable education systems, free labour and capital movements and so on, any initial differences in income levels should gradually be evened out. Instead, the gap has widened since the GFC.

A variety of explanations, or excuses, have been offered for New Zealand's sharp deterioration in economic performance. Among the excuses, the most popular is to claim that New Zealand's problems can be explained by the loss of agricultural markets arising from UK entry into the (then) EEC. Along with the oil shock of 1973, and the immediate macro responses (a failed attempt by Labour to stave off adjustment, followed by a sharp contraction under the Muldoon National government), this helps to explain NZ's relative decline up to 1984, when the Lange government started the reform process.

However, this explanation fails for at least three reasons:

1) The shock was not nearly big enough to explain a sustained 30 per cent divergence in GDP per person. Agriculture was only about 12 per cent of GDP at the start of the process, and is only about 8 per cent now.
2) The loss of market access was temporary, and the restoration of access coincided with the reform period. The EU butter mountain reached its maximum height in 1986 and has now disappeared. NZ is now the main exporter of lamb to the EU as a whole, not just the UK and in addition has an export wine industry that didn't exist in 1970

3) Even the most sclerotic economy shouldn't take 40 years to adjust to a terms of trade shock, and the whole point of the reforms was to make the economy flexible enough to respond to such shocks.

Macroeconomic mistakes cannot explain the entire deterioration in New Zealand's relative performance, but the gap is too large to be explained by terms of trade effects, or by mismanaged microeconomic policies. Anyone who could seriously suggest NZ as an economic model should not be entrusted with the management of our economy.

Other International Comparisons

Figure 1 shows the performance of a number of OECD economies on the standard measure of economic activity, namely Gross Domestic Product (because of the improvement in our terms of trade, Australia does even better on measures of Gross National Income (GNI) or Net National Income (NNI). NNI measure is more relevant to economic wellbeing than GDP. However, because the terms of trade are outside our control, GDP is a better measure of short-run macroeconomic performance.)

The countries listed fall into three main groups, which between them are broadly representative of the developed world as a whole. At the bottom are European countries (Greece, Italy, Spain) that have been forced into the adoption of radical austerity measures, largely because of the extreme anti-Keynesian position taken by the European Central Bank. Greece has suffered particularly severely, but Italy and Spain are also far below their pre-crisis GDP levels. This group is representative of most of the peripheral states in the Eurozone

The middle group are countries that undertook some initial fiscal stimulus, and where the subsequent turn to austerity has been less severe. These countries have experienced little or no net growth since the beginning of the crisis five years ago, but at least they have not gone backward. Canada, New Zealand and Japan are in a similar position.

The third group has a single member - Australia. The Labor government introduced a strong fiscal stimulus in 2009, and has unwound it only gradually. The results are evident in our economic performance. Alone among the major developed economies, we avoided any significant decline in GDP, even when the commodity prices on which we depend crashed in 2009.Examination of the labour market tells a similar story. In Figure 3, we present the data where we see that although the unemployment rate increased slightly, it has come down again (although not back to the pre-GFC level). All the other countries had higher unemployment rates than Australia in the post-2008 period. Only at the end of 2012 did Germany catch up with the Australian economy. Countries like Greece and Spain that are going through a significant financial crisis and the imposition of austerity measures to satisfy the lenders, the European Central Bank and the International Monetary Fund (IMF), have had a dramatic increase in unemployment rates. The austerity measures were supposed to help these economies to recover, but it appears that the situation has only got worse[11]. Youth unemployment rates in many of the Eurozone countries have escalated to almost fifty per cent, leaving a younger generation scarred for life.

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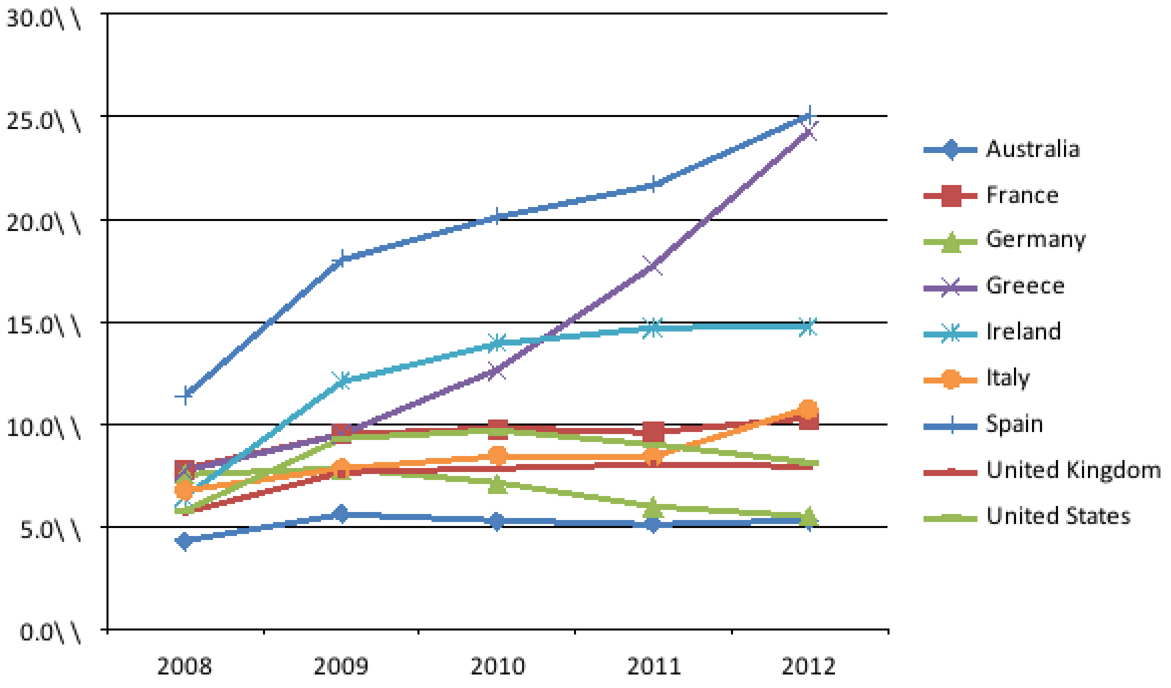
[11] In a recent report, the Blanchard and Leigh (2013) admitted that it had underestimated the impact of austerity policies. Also see " IMF admits: we failed to realise the damage austerity would do to Greece' *Guardian* 6th June 2013.

Figure 3: Unemployment Rates in the OECD



Source: OECD (2013) *Short-term labour market statistics: Harmonised Unemployment Rates (HURS).*

The OECD has endorsed the stellar performance and sound management of the Australian economy. For example, in its recent report on the Australian economy it said:

> *"Australia has continued to weather the global economic crisis well reflecting sound macroeconomic policies and strong demand from China. Growth temporarily slowed in 2010 and 2011 as stimulus was withdrawn and households became more cautious. Non-mining tradable sectors have struggled with the strong exchange rate driven by the mining boom. However, fundamentals remain solid with the unemployment rate close to its structural rate and inflation and public debt low. Growth strengthened in 2012, and the outlook is positive, even though there are mainly negative risks stemming from the external environment, to which Australia is however less vulnerable than many other OECD countries."*
>
> *"With 21 years of uninterrupted growth Australia stands out among OECD countries."* [12]

[12] OECD (2012) *Economic Survey of Australia 2012*.

Conclusion

The failure of Classical economics is evident throughout the world. As in the Great Depression, austerity policies have produced massive unemployment wherever they have been applied. By contrast, Australia's highly successful macroeconomic performance is the result of the application of Keynesian economic policies when they most mattered, at the time of the Global Financial Crisis.

In these circumstances, it is surprising that we should be having an economic policy debate at all, let alone that the failed policies of Classical economics should be taken seriously. Tony Abbott's suggestion that the crucial test of fiscal policy is the maintenance of budget surpluses regardless of economic conditions is a reflection of his economic illiteracy. Such a policy implies profligacy in boom periods, when large surpluses are required. More importantly, it is a recipe for economic catastrophe in times when external shocks create a threat of recession, at the time of the GFC.

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Appendix A - The multiplier and crowding out effects

The key issues here may be understood in terms of the Keynesian concept of the multiplier and the anti-Keynesian idea of 'crowding out'. These concepts have been around since the 1930s, and play a central role in the debate over fiscal policy. However, they have been obscured by the elaborate sophistication of more recent models. So, it's worth taking a little time to see how they work.

The idea of the multiplier is simple, though some elementary mathematics is required to get the full picture. Suppose that, in a depressed economy, the government spends money on a new project, hiring additional workers and bringing previously idle capital into use. Some of this money will return to the government through tax payments and reduced unemployment benefits. Of the remainder, some will be saved, and some spent on additional consumption of goods and services, which may either be produced in Australia or imported.

The money spent by households will create additional demand for goods and services, leading businesses to rehire unemployed workers and bring idle capital back into production. The newly hired workers, in turn, will spend some of their additional income. This second round effect will further increase demand, and so on.

The point can be illustrated arithmetically. A simple, but reasonably realistic assumption is that, for each $100 initially spent on public projects, $25 returns to the government in taxes, $25 is saved, and $50 is spent on consumption, with two-thirds of that, or $33, being spent in Australia.

In this case, the initial $100 raises consumer expenditure by $33. In turn, the recipients of this expenditure spend a further one-third of the $33, or $11, and so on. High school algebra allows us to work out that the series $100+$33+$11… sums to $100*(1/(1-1/3) or $150. So, the total value economic activity increases more than the initial expenditure by a factor of 1.5. This factor is the Keynesian multiplier.

There's a further benefit to the government. In this simple example, government revenue is 25 per cent of the economy, so the government gets back 0.25*150 or $37.50 of the original $100. Meaning that the net increase in the government's budget deficit is only $62.50.

The multiplier analysis only works if government spending results in the employment of previously unemployed workers and capital. It follows that, on a Keynesian analysis, the multiplier will be large under recession conditions. By contrast, in boom conditions, new workers will have to be attracted away from existing employment, for example by offering higher wages. In these conditions, the multiplier will be zero, or even negative if the new public sector jobs are less productive than the old ones. The only effect of additional public spending under these conditions will be to increase inflationary pressures.

The Keynesian analysis of the multiplier implies that governments can reduce unemployment in recessions by allowing the budget to go into deficit (fiscal stimulus) and reduce inflation in booms by increasing the budget surplus (fiscal contraction). The net effect is to raise average output and employment by reducing the frequency of recessions, in which the output of the economy is below its capacity

The effects of Keynesian demand management on long-term economic growth are less clear cut. Most macroeconomic analysis is based on the assumption that the long-term growth path of the economy is independent of macroeconomic fluctuations. On this view, Keynesian policies may reduce the frequency of recessions, and thereby increase average output, but cannot affect the long-term rate of economic growth.

However, there is increasingly strong evidence that severe and long-lasting recessions can push the economy on to a lower growth path. This can happen because long periods of unemployment destroy the job skills of workers or because the knowledge embodied in particular firms is lost when they go bankrupt. In addition, in an open economy, skilled workers and capital owners may emigrate, reducing the productivity of the economy as a whole. Some or all of these factors appear to be relevant in explaining the poor economic performance of New Zealand, discussed in the following section.

The most important counter to the Keynesian analysis of fiscal policy was the idea of 'crowding out'. The central idea of crowding out is that expansionary fiscal policy will require the government to issue additional debt. In the absence of accommodating changes in monetary policy, increased sales of debt will lead to higher interest rates, and therefore to lower private borrowing both for consumption and, more importantly, for investment. The result is that higher government spending 'crowds out' private investment that is presumed to be more effective.

This argument can be traced back at least as far as the 'Treasury view' put forward in the UK in the 1920s, in opposition to proposals for fiscal stimulus to life the country out of the recession arising from the deflationary policies of Winston Churchill, then Chancellor of the Exchequer (equivalent to our Treasurer) who argued:

It was to refute these ideas that Keynes developed the *General Theory of Employment, Interest and Money*. Keynes' basic insight was that the Treasury view worked under conditions of full employment, but that a more general theory was needed to deal with the case of recession or depression, when unemployment levels could remain high for long periods. Keynes argued that policies of fiscal expansion would work well when demand was weak, particularly in the 'liquidity trap' situation where interest rates are close to zero. By contrast, in a boom, fiscal austerity would reduce interest rates, and make room for private sector expansion, exactly as in the Treasury view of the world.

The Keynesian case for fiscal policy is most clearly applicable when the interest rate controlled by the central bank (the Federal Funds rate in the US or the Reserve Bank cash rate in Australia. However, fiscal policy is relevant under recession conditions more generally. Historically, monetary policy has proved very effective at choking off booms, but much less successful in stimulating a recovery, since firms are unwilling to invest even when interest rates are cut (the phrase 'pushing on a string' is an apt metaphor). The experience of the 'recession we had to have', discussed below, illustrates this point.

The failure of austerity policies, both during the Depression and in the years since the GFC, contrasted with the success of Keynesian stimulus in the post-war era and in response to the GFC, ought to have demonstrated, once and for all, the validity of Keynes analysis. The idea that, even under recession conditions, a budget deficit will give rise to higher interest rates and thereby result in economic contraction was, until recently, supported by some economists, who advocated austerity policies in the aftermath of the GFC. However, a combination of harsh experience and the exposure of serious errors in some of the key papers supporting this position have led the great majority of the economics profession back to a Keynesian view of the macroeconomy.

Unfortunately, the revival of Keynesianism within the economics profession has had little impact on the thinking and rhetoric of politicians and policymakers. The idea that budget deficits will lead to higher interest rates remains a fixture of political rhetoric, notably from the LNP Opposition in Australia.